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all covered positions. The risk factors must address, at a minimum, the following major risk categories: interest rate risk, equity price risk, foreign exchange rate risk, and commodity price risk. For material exposures in the major currencies and markets, modeling techniques must capture, at a minimum, spread risk and must incorporate enough segments of the yield curve to capture differences in volatility and less-than-perfect correlation of rates along the yield curve. An OTC derivatives dealer must provide the Commission with evidence that the OTC derivatives dealer's VAR model takes account of specific risk in positions, including specific equity risk, if the OTC derivatives dealer intends to utilize its VAR model to compute capital charges for equity price risk.

[63 FR 59398, Nov. 3, 1998]

§ 240.15c3-1g Conditions for ultimate holding companies of certain brokers or dealers (Appendix G to 17 CFR 240.15c3-1).

As a condition for a broker or dealer to compute certain of its deductions to capital in accordance with § 240.15c3-1e, pursuant to its undertaking, the ultimate holding company of the broker or dealer shall:

CONDITIONS REGARDING COMPUTATION OF ALLOWABLE CAPITAL AND RISK ALLOWANCES

(a) If it is not an ultimate holding company that has a principal regulator, as that term is defined in § 240.15c3-1(c)(13), calculate allowable capital and allowances for market, credit, and operational risk on a consolidated basis as follows:

(1) *Allowable capital.* The ultimate holding company must compute allowable capital as the sum of:

(i) Common shareholders' equity on the consolidated balance sheet of the holding company less:

(A) Goodwill;

(B) Deferred tax assets, except those permitted for inclusion in Tier 1 capital by the Board of Governors of the Federal Reserve System ("Federal Reserve") (12 CFR 225, appendix A);

(C) Other intangible assets; and

(D) Other deductions from common stockholders' equity as required by the

Federal Reserve in calculating Tier 1 capital (as defined in 12 CFR 225, appendix A);

(ii) Cumulative and non-cumulative preferred stock, except that the amount of cumulative preferred stock may not exceed 33% of the items included in allowable capital pursuant to paragraph (a)(1)(i) of this appendix G, excluding cumulative preferred stock, provided that:

(A) The stock does not have a maturity date;

(B) The stock cannot be redeemed at the option of the holder of the instrument;

(C) The stock has no other provisions that will require future redemption of the issue; and

(D) The issuer of the stock can defer or eliminate dividends;

(iii) The sum of the following items on the consolidated balance sheet, to the extent that the sum does not exceed the sum of the items included in allowable capital pursuant to paragraphs (a)(1)(i) and (ii) of this Appendix G:

(A) Cumulative preferred stock in excess of the 33% limit specified in paragraph (a)(1)(ii) of this appendix G and subject to the conditions of paragraphs (a)(1)(ii)(A) through (D) of this appendix G;

(B) Subordinated debt if the original weighted average maturity of the subordinated debt is at least five years; each subordinated debt instrument states clearly on its face that repayment of the debt is not protected by any Federal agency or the Securities Investor Protection Corporation; the subordinated debt is unsecured and subordinated in right of payment to all senior indebtedness of the ultimate holding company; and the subordinated debt instrument permits acceleration only in the event of bankruptcy or reorganization of the ultimate holding company under Chapters 7 (liquidation) and 11 (reorganization) of the U.S. Bankruptcy Code; and

(C) As part of the broker's or dealer's application to calculate deductions for market and credit risk under § 240.15c3-1e, an ultimate holding company may request to include, for a period of three years after adoption of this appendix G, long-term debt that has an original

weighted average maturity of at least five years and that cannot be accelerated, except upon the occurrence of certain events as the Commission may approve. As part of a subsequent amendment to the broker's or dealer's application, the broker or dealer may request permission for the ultimate holding company to include long-term debt that meets these criteria in allowable capital for up to an additional two years; and

(iv) Hybrid capital instruments that are permitted for inclusion in Tier 2 capital by the Federal Reserve (as defined in 12 CFR 225, appendix A);

(2) *Allowance for market risk.* The ultimate holding company shall compute an allowance for market risk for all proprietary positions, including debt instruments, equity instruments, commodity instruments, foreign exchange contracts, and derivative contracts, as the aggregate of the following:

(i) *Value at risk.* The VaR of its positions, multiplied by the appropriate multiplication factor as set forth in § 240.15c3-1e(d). The VaR of the positions must be obtained using approved VaR models meeting the applicable qualitative and quantitative requirements of § 240.15c3-1e(d); and

(ii) *Alternative method.* For positions for which there does not exist adequate historical data to support a VaR model, the ultimate holding company must propose a model that produces a suitable allowance for market risk for those positions;

(3) *Allowance for credit risk.* The ultimate holding company shall compute an allowance for credit risk for certain assets on the consolidated balance sheet and certain off-balance sheet items, including loans and loan commitments, exposures due to derivatives contracts, structured financial products, and other extensions of credit, and credit substitutes as follows:

(i) By multiplying the credit equivalent amount of the ultimate holding company's exposure to the counterparty, as defined in paragraphs (a)(3)(i)(A), (B) and (C) of this appendix G, by the appropriate credit risk weight, as defined in paragraph (a)(3)(i)(F) of this appendix G, of the asset, off-balance sheet item, or counterparty, then multiplying that

product by 8%, in accordance with the following:

(A) For certain loans and loan commitments, the credit equivalent amount is determined by multiplying the nominal amount of the contract by the following credit conversion factors:

(1) 0% credit conversion factor for loan commitments that:

(i) May be unconditionally cancelled by the lender; or

(ii) May be cancelled by the lender due to credit deterioration of the borrower;

(2) 20% credit conversion factor for:

(i) Loan commitments of less than one year; or

(ii) Short-term self-liquidating trade related contingencies, including letters of credit;

(3) 50% credit conversion factor for loan commitments with an original maturity of greater than one year that contain transaction contingencies, including performance bonds, revolving underwriting facilities, note issuance facilities and bid bonds; and

(4) 100% credit conversion factor for bankers' acceptances, stand-by letters of credit, and forward purchases of assets, and similar direct credit substitutes;

(B) For derivatives contracts and for repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions, the credit equivalent amount is the sum of the ultimate holding company's maximum potential exposure to the counterparty, as defined in paragraph (a)(3)(i)(E) of this appendix G, multiplied by the appropriate multiplication factor, and the ultimate holding company's current exposure to the counterparty, as defined in paragraph (a)(3)(i)(D) of this appendix G. The ultimate holding company must use the multiplication factor determined according to § 240.15c3-1e(d)(1)(v), except that the initial multiplication factor shall be one, unless the Commission determines, based on a review of the group-wide internal risk management control system and practices, including a review of the VaR models, that another multiplication factor is appropriate;

(C) The credit equivalent amount for other assets shall be the asset's book

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value on the ultimate holding company's consolidated balance sheet or other amount as determined according to the standards published by the Basel Committee on Banking Supervision, as amended from time to time;

(D) The *current exposure* is the current replacement value of a counterparty's positions, after applying netting agreements with that counterparty meeting the requirements of § 240.15c3-1e(c)(4)(iv) and taking into account the value of collateral from the counterparty in accordance with § 240.15c3-1e(c)(4)(v);

(E) The *maximum potential exposure* is the VaR of the counterparty's positions with the member of the affiliate group, after applying netting agreements with the counterparty meeting the requirements of paragraph (c)(4)(iv) of § 240.15c3-1e, taking into account the value of collateral from the counterparty held by the member of the affiliate in accordance with paragraph (c)(4)(v) of § 240.15c3-1e, and taking into account the current replacement value of the counterparty's positions with the member of the affiliate group, except that for repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions, maximum potential exposure must be calculated using a time horizon of not less than five days;

(F) Credit ratings and credit risk weights shall be determined according to the provisions of paragraphs (c)(4)(vi)(D) and (c)(4)(vi)(E) of § 240.15c3-1e, respectively;

(G) As part of the broker's or dealer's initial application or in an amendment, the ultimate holding company may request Commission approval to reduce allowances for credit risk through the use of credit derivatives;

(H) For the portion of a current exposure covered by a written guarantee, where that guarantee is an unconditional and irrevocable guarantee of the due and punctual payment and performance of the obligation and the ultimate holding company or member of the affiliate group can demand payment after any payment is missed without having to make collection efforts, the ultimate holding company or member of the affiliate group may sub-

stitute the credit risk weight of the guarantor for the credit risk weight of the counterparty; or

(ii) As part of the broker's or dealer's initial application or in an amendment to the application, the ultimate holding company may request Commission approval to use a method of calculating credit risk that is consistent with standards published by the Basel Committee on Banking Supervision in International Convergence of Capital Measurement and Capital Standards (July 1988), as amended from time to time; and

(4) *Allowance for operational risk.* The ultimate holding company shall compute an allowance for operational risk in accordance with the standards published by the Basel Committee on Banking Supervision, as amended from time to time.

CONDITIONS REGARDING REPORTING REQUIREMENTS

(b) File reports with the Commission in accordance with the following:

(1) If it is not an ultimate holding company that has a principal regulator, as that term is defined in § 240.15c3-1(c)(13), the ultimate holding company shall file with the Commission:

(i) A report as of the end of each month, filed not later than 30 calendar days after the end of the month. A monthly report need not be filed for a month-end that coincides with a fiscal quarter-end. The monthly report shall include:

(A) A consolidated balance sheet and income statement (including notes to the financial statements) for the ultimate holding company and statements of allowable capital and allowances for market, credit, and operational risk computed pursuant to paragraph (a) of this appendix G, *except* that the consolidated balance sheet and income statement for the first month of the fiscal year may be filed at a later time to which the Commission agrees (when reviewing the affiliated broker's or dealer's application under § 240.15c3-1e(a)).

(B) A graph reflecting, for each business line, the daily intra-month VaR;

(C) Consolidated credit risk information, including aggregate current exposure and current exposures (including commitments) listed by counterparty for the 15 largest exposures;

(D) The 10 largest commitments listed by counterparty;

(E) Maximum potential exposure listed by counterparty for the 15 largest exposures;

(F) The aggregate maximum potential exposure;

(G) A summary report reflecting the geographic distribution of the ultimate holding company's exposures on a consolidated basis for each of the top ten countries to which it is exposed (by residence of the main operating group of the counterparty); and

(H) Certain regular risk reports provided to the persons responsible for managing group-wide risk as the Commission may request from time to time;

(ii) A quarterly report as of the end of each fiscal quarter, filed not later than 35 calendar days after the end of the quarter. The quarterly report shall include, in addition to the information contained in the monthly report as required by paragraph (b)(1)(i) of this appendix G, the following:

(A) Consolidating balance sheets and income statements for the ultimate holding company. The consolidating balance sheet must provide information regarding each material affiliate of the ultimate holding company in a separate column, but may aggregate information regarding members of the affiliate group that are not material affiliates into one column;

(B) The results of backtesting of all internal models used to compute allowable capital and allowances for market and credit risk indicating, for each model, the number of backtesting exceptions;

(C) A description of all material pending legal or arbitration proceedings, involving either the ultimate holding company or any of its affiliates, that are required to be disclosed by the ultimate holding company under generally accepted accounting principles;

(D) The aggregate amount of unsecured borrowings and lines of credit, segregated into categories, scheduled

to mature within twelve months from the most recent fiscal quarter as to each material affiliate; and

(E) For a quarter-end that coincides with the ultimate holding company's fiscal year-end, the ultimate holding company need not include consolidated and consolidating balance sheets and income statements in its quarterly reports. The consolidating balance sheet and income statement for the quarter-end that coincides with the fiscal year-end may be filed at a later time to which the Commission agrees (when reviewing the affiliated broker's or dealer's application under § 240.15c3-1e(a));

(iii) An annual audited report as of the end of the ultimate holding company's fiscal year, filed not later than 65 calendar days after the end of the fiscal year. The annual report shall include:

(A) Consolidated financial statements for the ultimate holding company audited by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.). The audit shall be made in accordance with the rules promulgated by the Public Company Accounting Oversight Board. The audited financial statements must include a supporting schedule containing statements of allowable capital and allowances for market, credit, and operational risk computed pursuant to paragraph (a) of this appendix G; and

(B) A supplemental report entitled "Accountant's Report on Internal Risk Management Control System" prepared by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.), indicating the results of the registered public accounting firm's review of the ultimate holding company's compliance with § 240.15c3-4. The procedures are to be performed and the report is to be prepared in accordance with procedures agreed upon by the ultimate holding company and the registered public accounting firm conducting the review. The agreed-upon procedures are to be performed and the report is to be prepared in accordance with rules promulgated by the Public Company Accounting Oversight Board. The ultimate

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holding company must file, before commencement of the initial review, the procedures agreed upon by the ultimate holding company and the registered public accounting firm with the Division of Market Regulation, Office of Financial Responsibility, at Commission's principal office in Washington, DC. Before commencement of each subsequent review, the ultimate holding company must notify the Commission of any changes in the procedures;

(iv) An organizational chart, as of the ultimate holding company's fiscal year-end, concurrently with its quarterly report for the quarter-end that coincides with its fiscal year-end. The ultimate holding company must provide quarterly updates of the organizational chart if a material change in the information provided to the Commission has occurred;

(2) If the ultimate holding company is an entity that has a principal regulator, as that term is defined in § 240.15c3-1(c)(13), the ultimate holding company must file with the Commission:

(i) A quarterly report as of the end of each fiscal quarter, filed not later than 35 calendar days after the end of the quarter, or a later time to which the Commission may agree upon application. The quarterly report shall include:

(A) Consolidated (including notes to the financial statements) and consolidating balance sheets and income statements for the ultimate holding company;

(B) Its most recent capital measurements computed in accordance with the standards published by the Basel Committee on Banking Supervision, as amended from time to time, as reported to its principal regulator;

(C) Certain regular risk reports provided to the persons responsible for managing group-wide risk as the Commission may request from time to time; and

(D) For a quarter-end that coincides with the ultimate holding company's fiscal year-end, the ultimate holding company need not include consolidated and consolidating balance sheets and income statements in its quarterly reports. The consolidating balance sheet

and income statement for the quarter-end that coincides with the fiscal year-end may be filed at a later time to which the Commission agrees (when reviewing the affiliated broker's or dealer's application under § 240.15c3-1e(a)).

(ii) An annual audited report as of the end of the ultimate holding company's fiscal year, filed with the Commission when required to be filed by any regulator;

(3) The reports that the ultimate holding company must file in accordance with paragraph (b) of this appendix G will be considered filed when two copies are received at the Commission's principal office in Washington, DC. A person who files reports pursuant to this section for which he or she seeks confidential treatment may clearly mark each page or segregable portion of each page with the words "Confidential Treatment Requested." The copies shall be addressed to the Division of Market Regulation, Risk Assessment Group; and

(4) The reports that the ultimate holding company must file with the Commission in accordance with paragraph (b) of this Appendix G will be accorded confidential treatment to the extent permitted by law.

CONDITIONS REGARDING RECORDS TO BE MADE

(c) If it is not an ultimate holding company that has a principal regulator, make and keep current the following records:

(1) A record of the results of funding and liquidity stress tests that the ultimate holding company has conducted in response to the following events at least once each quarter and a record of the contingency plan to respond to each of these events:

(i) A credit rating downgrade of the ultimate holding company;

(ii) An inability of the ultimate holding company to access capital markets for unsecured short-term funding;

(iii) An inability of the ultimate holding company to access liquid assets in regulated entities across international borders when the events described in paragraphs (c)(1)(i) or (ii) of this appendix G occur; and

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(iv) An inability of the ultimate holding company to access credit or assets held at a particular institution when the events described in paragraphs (c)(1)(i) or (ii) of this appendix G occur;

(2) A record of the basis for the determination of credit risk weights for each counterparty;

(3) A record of the basis for the determination of internal credit ratings for each counterparty; and

(4) A record of the calculations of allowable capital and allowances for market, credit and operational risk computed currently at least once per month on a consolidated basis.

CONDITIONS REGARDING PRESERVATION OF RECORDS

(d)(1) Must preserve the following information, documents, and reports for a period of not less than three years in an easily accessible place using any media acceptable under § 240.17a-4(f):

(i) The documents created in accordance with paragraph (c) of this Appendix G;

(ii) Any application or documents filed with the Commission pursuant to § 240.15c3-1e and this appendix G and any written responses received from the Commission;

(iii) All reports and notices filed with the Commission pursuant to § 240.15c3-1e and this appendix G; and

(iv) If the ultimate holding company does not have a principal regulator, all written policies and procedures concerning the group-wide internal risk management control system established pursuant to § 240.15c3-1e(a)(1)(viii)(C); and

(2) The ultimate holding company may maintain the records referred to in paragraph (d)(1) of this appendix G either at the ultimate holding company, at an affiliate, or at a records storage facility, provided that the records are located within the United States. If the records are maintained by an entity other than the ultimate holding company, the ultimate holding company shall obtain and file with the Commission a written undertaking by the entity maintaining the records, in a form acceptable to the Commission, signed by a duly authorized person at the entity maintaining the records, to

the effect that the records will be treated as if the ultimate holding company were maintaining the records pursuant to this section and that the entity maintaining the records will permit examination of such records at any time or from time to time during business hours by representatives or designees of the Commission and will promptly furnish the Commission or its designee a true, legible, complete, and current paper copy of any or all or any part of such records. The election to operate pursuant to the provisions of this paragraph shall not relieve the ultimate holding company that is required to maintain and preserve such records from any of its reporting or recordkeeping responsibilities under this section.

CONDITIONS REGARDING NOTIFICATION

(e) The ultimate holding company of a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e shall:

(1) Send notice promptly (but within 24 hours) after the occurrence of the following events:

(i) The early warning indications of low capital as the Commission may agree;

(ii) The ultimate holding company files a Form 8-K (17 CFR 249.308) with the Commission; and

(iii) A material affiliate declares bankruptcy or otherwise becomes insolvent; and

(2) If it is not an ultimate holding company that has a principal regulator, as defined in § 240.15c3-1(c)(13), send notice promptly (but within 24 hours) after the occurrence of the following events:

(i) The ultimate holding company becomes aware that an NRSRO has determined to reduce materially its assessment of the creditworthiness of a material affiliate or the credit rating(s) assigned to one or more outstanding short or long-term obligations of a material affiliate;

(ii) The ultimate holding company becomes aware that any financial regulatory agency or self-regulatory organization has taken significant enforcement or regulatory action against a material affiliate; and

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(iii) The occurrence of any backtesting exception under § 240.15c3-1e(d)(1)(iii) or (iv) that would require that the ultimate holding company use a higher multiplication factor in the calculation of its allowances for market or credit risk;

(3) Every notice given or transmitted by paragraph (e) of this appendix G will be given or transmitted to the Division of Market Regulation, Office of Financial Responsibility, at the principal office of the Commission in Washington, DC. A person who files notification pursuant to this section for which he or she seeks confidential treatment may clearly mark each page or segregable portion of each page with the words "Confidential Treatment Request." For the purposes of this appendix G, "notice" shall be given or transmitted by telegraphic notice or facsimile transmission. The notice described by paragraph (e)(2) of this appendix G may be transmitted by overnight delivery. Notices filed pursuant to this paragraph will be accorded confidential treatment to the extent permitted by law; and

(4) Upon the written request of the ultimate holding company, or upon its own motion, the Commission may grant an extension of time or an exemption from any of the requirements of this paragraph (e) either unconditionally or on specified terms and conditions as are necessary or appropriate in the public interest or for the protection of investors.

[69 FR 34467, June 21, 2004]

§ 240.15c3-2 Customers' free credit balances.

No broker or dealer shall use any funds arising out of any free credit balance carried for the account of any customer in connection with the operation of the business of such broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent, together with or as a part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement informing such customer of the amount due to the customer by such broker or dealer on the

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date of such statement, and containing a written notice that (a) such funds are not segregated and may be used in the operation of the business of such broker or dealer, and (b) such funds are payable on the demand of the customer: *Provided, however*, That this section shall not apply to a broker or dealer which is also a banking institution supervised and examined by State or Federal authority having supervision over banks. For the purpose of this section the term *customer* shall mean every person other than a broker or dealer.

(Sec. 15, 48 Stat. 895; 15 U.S.C. 78o)

[29 FR 7240, June 3, 1964]

§ 240.15c3-3 Customer protection—reserves and custody of securities.

(a) *Definitions.* For the purpose of this section:

(1) The term *customer* shall mean any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of that person. The term shall not include a broker or dealer, a municipal securities dealer, or a government securities broker or government securities dealer. The term shall, however, include another broker or dealer to the extent that broker or dealer maintains an omnibus account for the account of customers with the broker or dealer in compliance with Regulation T (12 CFR 220.1 through 220.19). The term shall not include a general partner or director or principal officer of the broker or dealer or any other person to the extent that person has a claim for property or funds which by contract, agreement or understanding, or by operation of law, is part of the capital of the broker or dealer or is subordinated to the claims of creditors of the broker or dealer. In addition, the term shall not include a person to the extent that the person has a claim for security futures products held in a futures account, or any security futures product and any futures product held in a "proprietary account" as defined by the Commodity Futures Trading Commission in § 1.3(y) of this chapter. The term also shall not include a counterparty who has delivered collateral to an OTC derivatives